

An Austrian Economic View of Legal Process

LINDA A. SCHWARTZSTEIN*

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I. INTRODUCTION

Contemporary jurisprudence is struggling to find a convincing and coherent theory of legal process. The Austrian school of economics, which emphasizes “market process,” provides a valuable framework for examining the evolution of law. Austrian economists, and especially Friedrich Hayek, have stressed the importance of the market as a means of communicating information through prices and as a coordinating mechanism among disperse members of society. Austrians see the market as an important societal institution and focus on the contribution the market makes to a society’s development and success and on how social institutions either flourish or die.

The Austrian school also recognizes that individuals act under conditions of uncertainty and ignorance. The market process makes it possible for individuals to decrease the uncertainty and lessen the ignorance, but those variables can never be eliminated because much is unknown to anyone, much less communicated. Part of the market process

* Professor of Law, George Mason University; A.B., Brandeis University, 1973; J.D., University of Michigan, 1976; LL.M. in Taxation, New York University, 1977; Ph.D. Economics, George Mason University, 1994. I would like to thank Richard Wagner, Karen Vaughn, and Stephen Crafton for their helpful comments. I wish to acknowledge the generous research funding provided by the John M. Olin and Sarah Scaife Foundations.

is the opportunity for entrepreneurs to capitalize on ignorance and seize or create opportunities that others did not recognize. Successful entrepreneurs are rewarded.

The Austrians emphasize the concept of subjectiveness. The market process is the foil upon which individuals test their subjective views against those of others, and provides, through the mechanism of market prices, the information they need to adjust their expectations to the current prevailing economic conditions. Subjectivism means that all human interaction begins with a person's subjective thoughts, with each individual being guided by his or her knowledge, intuition, and imagination. People act according to the opportunities they perceive, choosing what they believe at the time to be the best alternative. The result of an individual's choice may or may not be that which was expected. The unexpected may occur because an individual did not correctly perceive the outcome of his or her action. The unexpected may also occur because individual actions are impacted by and impact upon other members of society. The actual outcome is unknowable *ex ante*. However, once the action is taken, the result of the action may become known through the market, and this knowledge is then shared among market participants who in turn may incorporate this knowledge into their own information base and adjust their future actions accordingly.

The thesis of this Article is that these central tenets of Austrian economics can be applied to legal process and lead to insights into legal institutions. Examining law from an Austrian economic perspective thus adds to the jurisprudence of the legal process. In addition, this Article advances existing Austrian theory regarding the evolution of social institutions. Just as Austrian economics emphasizes the market as a discovery process, this Article will show that law is also a discovery process. The Article concludes that legal process and legal institutions should work to diffuse knowledge throughout society, to make it possible for people to engage in their daily lives with an economy of knowledge, and to make it easier for market participants to coordinate their plans with those of others.

The need for a theory of legal process and legal institutions is of special importance now. The legal system is under intellectual attack by critical legal studies, promoted by the "Crits," which argues that the system is designed to oppress the powerless for the benefit of special interests and that the powerful few can and do manipulate the law to serve their interests over those of the less powerful in society. Law and economics, which has stood as the major counter-argument to critical legal studies, has argued that the overriding principle and thrust of the law is to

establish efficient rules which maximize the use of society's resources. However, recently, advocates of law and economics themselves have cast doubt on the validity of this theory. Two new lines of inquiry within law and economics are now emerging. One looks at litigators as an interest group trying to maximize causes of action for their own economic benefit. The other analyzes judicial behavior by identifying what judges maximize, given assumptions about their preferences. Ironically, these lines of inquiry within the law and economics movement lead to conclusions that are similar in many respects to those of the Critics. That is, basically, that the legal process is constantly manipulated to serve the private ends of lawyers and judges. Given that both critical legal studies and the recent trends in law and economics suggest that there are no underlying values or rights that are protected or advanced through the legal system, both theories, if taken to their logical conclusions, create a rather nihilistic view of the law. Neither theory leads to any policy implications for what the goals should be for the legal process or any guidance as to how best to achieve those goals.¹

II. TRADITIONAL LAW AND ECONOMIC THEORIES OF LEGAL INSTITUTIONS

A. *Efficiency Theories*

Much of the law and economics literature of the past several decades has been concerned with the efficiency of the common law.² This theory, largely championed by Posner, asserts that the common law is best explained as a system for maximizing the wealth of society.³ Where

¹ For a comparison of law and economics, critical legal studies, and Austrian economics, see Linda A. Schwartzstein, *Austrian Economics and the Current Debate Between Critical Legal Studies and Law and Economics*, 20 HOFSTRA L. REV. 1105 (1992).

² The definition of efficiency that is used is the Kaldor-Hicks definition of wealth maximization. RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 15 (4th ed. 1992). For a history of the law and economics movement, see Edmund W. Kitch, *The Intellectual Foundations of "Law and Economics,"* 33 J. LEGAL EDUC. 184 (1983); POSNER, *supra* 21-22.

³ POSNER, *supra* note 2, at 23. Posner does not claim that there is an economic rationale for every common law doctrine, but asserts that economics has the most explanatory force and provides a unifying theory for examining the legal system. See *id.* at 255. At another point, Posner states that "[t]he common law's commitment to efficiency is strong, but not total." *Id.* at 263.

transaction costs are low, the common law is said to have developed doctrines that created incentives for people to participate in the market by creating property rights and enforcement mechanisms to prevent coerced transactions. Where transaction costs are high, the common law is said to have developed doctrines which imitate the market by pricing behavior so as to simulate what would have occurred if a market transaction was feasible.⁴ The common law also serves to correct externalities and to reduce transaction costs.⁵ Thus Posner summarizes the role of the common law as follows:

The law thus tries to guess where the parties would want (ex ante) to allocate some burden or benefit, such as responsibility if some happy, or harmful, contingency materializes. If it guesses right, this both minimizes the costs of transacting by making it unnecessary for the parties to transact around the law's allocation, and produces the efficient allocation of resources if transaction costs are prohibitive.⁶

Posner asserts that the common law tends to be efficiency enhancing because of the structure of the adversary system. Legal process mimics the market by providing compensatory damages based on opportunity costs.

⁴ *Id.* at 252.

⁵ *Id.* at 254.

⁶ *Id.* Austrians would criticize this anthropomorphism of the law as problematic. How can the law "guess"? Clearly only individuals can guess. Is Posner referring to individual judges or litigants? In addition, Austrians would argue that one should examine critically the concept that whoever is "guessing" has the requisite knowledge or ability to imagine what the correct "price" would be in an imaginary market transaction for the same reasons that Austrians vehemently object to the possibility of a centrally planned economy being able to successfully emulate the market. Further, when Posner asserts the following, describing the development of the law regarding liability of railroads in the nineteenth century, he appears to ascribe to the judge a knowledge and ability to make judgments that Austrians would argue is impossible for any mind or group of minds to have.

If the courts chose the less costly (to railroads) of the two efficient liability rules because they sensed that railroad revenues were less than they should be to stimulate the economically correct level of investment in the railroad industry, they may have been nudging the economy a bit closer to the most efficient employment of its resources.

Id. at 258. Given that Posner along with many other neoclassical economists share the Austrians' belief that a centrally planned economy could never achieve that which a free market can, it is surprising to see this assertion.

Also, similar to the market process, the legal process depends on individuals, motivated by self-interest, challenging inefficient rules. In doing so, such individuals bear most of the costs of adjudication. These include the costs of finding facts; gathering information; organizing and presenting the relevant legal rules, facts, and circumstances; arguing for particular applications of the law or changes in applicability; and enforcing the judgment. The parties who invoke the adjudicatory process are "assured" of an impartial, impersonal, disinterested judge by the rules governing judicial functions, remuneration, and use of information beyond that presented by the parties.⁷ In addition to settling the dispute at issue, the case may have a social benefit of setting forth rules of conduct that others will follow in the future.⁸ The judge, since he has no personal interest in the case and does not know the litigants personally, is likely to focus on which of the competing activities is more valuable from an economic viewpoint. Since the judge is considering an actual set of facts, the issue of relative costs is more apparent.⁹ In addition, judges are less vulnerable to interest group pressure.¹⁰ Judges' sensitivity to being reversed by higher courts or by the legislature and the parties' ability in many cases to resort to contract to avoid an inefficient legal rule all limit the judges' ability to impose their own preferences and values when rendering a decision.¹¹

More formal economic models for why the common law would tend toward efficient rules have been developed.¹² In a 1977 article, *Why is the Common Law Efficient?*,¹³ Paul Rubin modeled the decision of whether to litigate or settle given an existing rule of tort liability to show that inefficient rules will more often be adjudicated rather than settled and in this way the litigants' own self-interest in making this decision will drive the common law towards efficiency. Rubin contended that it was unnecessary for Posner's efficiency argument to consider whether judges used efficiency criteria as a way of deciding cases. Rather, the direction of

⁷ *Id.* at 520-21.

⁸ *Id.* at 521.

⁹ *Id.* at 524.

¹⁰ *Id.*

¹¹ *Id.* at 535.

¹² For an overview of the development of this literature, see Peter H. Aranson, *Economic Efficiency and the Common Law: A Critical Survey*, in *LAW AND ECONOMICS & THE ECONOMICS OF LEGAL REGULATION* 51 (Int'l Studies in Econ. and Econometrics vol. 13, J. Matthais Graf von der Schulenberg & Göran Skogh eds., 1986).

¹³ Paul H. Rubin, *Why is the Common Law Efficient?*, 6 J. LEGAL STUD. 51 (1977).

the common law was directed by the "utility maximizing decisions of disputants rather than from the wisdom of judges."¹⁴ Rubin uses a question of tort liability to model this process and assumes that one can determine whether the efficient rule of liability is to hold the defendant liable or not given the present value of the costs to the defendant and to the victim of accident avoidance and accident costs. In addition, one must determine the likelihood that there is a positive probability that legal precedent, which would favor one of the parties, will be followed in a given case and that both parties agree on what that probability is.¹⁵ The law will tend towards efficiency most often where both parties to the litigation are interested in the outcome because it will affect their transactions in the future. In this situation, the litigants are interested in both the outcome of the particular case and the precedent it will establish. If the liability rule is inefficient, there will be an incentive to relitigate the rule to capture the future savings that would result from an efficient rule. If it is efficient, there is no incentive to do so. Rubin concludes that the litigants' decisions to sue or settle based on their own self-interests will result in only inefficient rules being litigated and efficient ones remaining stable. Rubin further states:

[A]n outside observer coming upon this legal rule would observe that the rule is efficient; but this efficiency occurs because of an evolutionary process, not because of any particular wisdom on the part of judges. If judges decide independently of efficiency, we would still find efficient rules. Intelligent judges may speed up the process of attaining efficiency; they do not drive the process.¹⁶

However, Rubin also asserts that if only one party has an interest in future cases, the tendency would be for the rule of liability to evolve which favors that party whether or not the rule is efficient because that party has an incentive to continue to relitigate the issue until a favorable ruling is obtained.¹⁷ Once such a ruling has been obtained, the party with only a one-shot interest in the outcome has more incentive to settle. This assertion implicitly means that judges do not use efficiency as a guide, which is the extreme opposite of Posner's view. Rubin asserts that if neither party is

¹⁴ *Id.* at 51; see also PAUL H. RUBIN, BUSINESS FIRMS AND THE COMMON LAW 5 (1983) (arguing that firms have a strong interest in pursuing litigation until an efficient rule is established because they can expect to internalize the cost savings that will result in the future); Paul H. Rubin, *Common Law and Statute Law*, 11 J. LEGAL STUD. 205 (1982).

¹⁵ Rubin, *supra* note 13, at 52.

¹⁶ *Id.* at 55.

¹⁷ *Id.*

interested in establishing a precedent, then there is no tendency for the law to favor efficiency because the parties will settle based on the existing rule and will not litigate the issue unless they disagree on the probability that precedent will be followed. Even in the event that the parties litigate the issue, Rubin makes no presumption that the efficient rule will be the one to emerge.¹⁸

Building on Rubin's model, George Priest argued that efficient rules will be more likely to endure than inefficient ones, regardless of the judges' bias towards efficiency, the ability of judges to distinguish efficient rules from inefficient ones, or the interests of the litigants in the allocative effects of the outcomes.¹⁹ The reason for this is that inefficient rules will always impose more costs than efficient ones. Since the stakes will be higher, there will be more value in relitigating them, and the more the rules are examined by the courts, the more likely it is that the efficient rule will emerge.²⁰ In addition, since inefficient rules will be the majority of those litigated, efficient rules will be the majority of those not litigated. Regardless of the judiciary's attitude towards efficiency, the total effect of the system of rules will be systematically more efficient.²¹

¹⁸ *Id.* at 57.

¹⁹ George L. Priest, *The Common Law Process and the Selection of Efficient Rules*, 6 J. LEGAL STUD. 65, 65 (1977).

²⁰ *Id.* at 67.

²¹ *Id.* at 68. In a later article, Priest argued that no one comprehensive explanation of the common law could be identified by looking at judicial decisions because of the selection bias concerning which cases are litigated. George L. Priest, *Selective Characteristics of Litigation*, 9 J. LEGAL STUD. 399 (1980). If the substantive standard of decision is efficiency, parties will only litigate when the efficient outcome is unclear or uncertain. If the parties could predict with a high degree of certainty what the relative costs and benefits would be of the outcome, the case would settle. Thus, the courts will get those cases in which the efficient rule is most difficult to determine and are as likely to formulate an inefficient rule as often as an efficient one, unless one ascribes special knowledge to the judge that the parties do not possess. Similarly, even if an efficient rule has been established by earlier case law, the only litigation that will arise is where that rule does not clearly apply. Thus, the law will appear to be indeterminate when viewed from any overarching framework, including efficiency, if only judicial decisions are examined. Priest concludes: "[I]f the efficiency standard has influence in the common law system, it will be reflected in settled rather than litigated cases." *Id.* at 412. Priest argues that more attention should be paid to the decisionmaking process with respect to whether to litigate or to settle. *Id.*

Mario J. Rizzo argues that one can discern a pattern of decisions even if one cannot make a prediction of a particular outcome based on some overarching explanation of the common law process. Mario J. Rizzo, *Can There Be a Principle of*

Other models have suggested mechanisms that work to make the common law move towards efficiency. John Goodman suggested that those with the greater stakes in a case will invest more in litigation and have a higher probability of prevailing. If the party with the lower stakes is the least cost avoider and the ratio of the litigants' private costs parallel that of the social benefits, the result will tend towards efficiency.²² William Landes and Richard Posner argue that parties will choose to contract away from inefficient rules if possible rather than litigate them, because contrary to the Rubin, Priest, and Goodman models, to the extent judges follow precedent, relitigating the rule may have the effect of reinforcing the inefficient rule.²³ If the existing rule is efficient, the parties may opt to litigate rather than contract away from the rule to increase the number of precedents and thus the stability of the rule, and the efficient rule will become more established over time. Landes and Posner state:

To say that the governing rule is inefficient is to say that cases within the domain of the rule are more likely to be decided inefficiently than efficiently, and every time that happens the rule is strengthened by the greater accretion of precedents. There will be less litigation of efficient rules and hence a smaller accumulation of precedents confirming and thereby (in a system of decision according to precedent) strengthening those rules.²⁴

Landes and Posner conclude that the previously developed models overstated the common law's tendency towards efficiency.²⁵ After reviewing the above models, one commentator argued that there was little

Explanation in Common Law Decisions? A Comment on Priest, 9 J. LEGAL STUD. 423, 426-27 (1980). However, Rizzo believes efficiency cannot be used as a normative goal. Further, he asserts "that the substantial information requirements that must be satisfied in order to identify efficient legal rules make efficiency impractical as a standard." Mario J. Rizzo, *The Mirage of Efficiency*, 8 HOFSTRA L. REV. 641, 658 (1980).

²² John C. Goodman, *An Economic Theory of the Evolution of Common Law*, 7 J. LEGAL STUD. 393, 394-95 (1978).

²³ William M. Landes and Richard A. Posner, *Adjudication as a Private Good*, 8 J. LEGAL STUD. 235, 259-63 (1979).

²⁴ *Id.* at 262-63.

²⁵ *Id.* at 284. *Contra* R. Peter Terrebonne, *A Strictly Evolutionary Model of Common Law*, 10 J. LEGAL STUD. 397, 400-04 (1981) (providing a model that infers that inefficient rules will be relitigated more often).

basis for choosing among the different models and their underlying assumptions.²⁶

B. *Alternative Law and Economic Theories*

In the wake of the questions that have arisen regarding the theory that the common law moves toward efficiency-promoting rules, alternative law and economic theories have been suggested.²⁷ Mario Rizzo argues that the common law must be efficient if measured against the revealed preferences of those who choose to use the courts to settle their differences (and he argues that this is the only relevant benchmark), but that it is not efficient if viewed from some set of preselected objectives such as maximizing societal wealth.²⁸ The former benchmark can take into account equity and other concerns while the latter cannot. In addition, Rizzo contends that the time frame within which one examines a rule for efficiency will affect whether the rule appears to be efficient or not. This is because technological developments and other factors change over time. A rule that may seem efficient in the short run may not be efficient in the long run or vice versa.²⁹ Further, in a distinctly Austrian argument, Rizzo argues that there can never be an objective measure of costs and benefits that would allow a judge to balance the two.³⁰ The relevant measure of cost, Rizzo asserts, is opportunity cost because all that can be determined is an

²⁶ Aranson, *supra* note 12. Aranson gives a more technical review of the Rubin, Priest, Landes and Posner, Terrebonne, and Cooter and Kornhauser models discussed here. Notably, Aranson acknowledges Rizzo's critique, based on Austrian economics, which would argue that information problems and preference revelation difficulties make it difficult for the legal system to determine rules of allocative efficiency. The preferred function of law is to state a clear doctrine, which sends decisionmaking back to the market.

²⁷ For a critical review of the methodology employed in the law and economics literature, see Christopher J. Bruce, *A Positive Analysis of Methodology in the Law and Economics Literature*, 12 *HAMLIN L. REV.* 197 (1989). Among Bruce's criticisms are that law and economics theorists have not adjusted their assumptions to take into account circumstances under which courts would fail to develop wealth maximizing rules and that there has been little empirical testing of these theories, even less so with a random sample of judicial decisions.

²⁸ Mario J. Rizzo, *Uncertainty, Subjectivity, and the Economic Analysis of Law, in TIME, UNCERTAINTY, AND DISEQUILIBRIUM* 71, 72 (Mario J. Rizzo ed., 1979) [hereinafter Rizzo, *Uncertainty, Subjectivity, Economic Analysis*]; see also Mario J. Rizzo, *The Mirage of Efficiency*, 8 *HOFSTRA L. REV.* 641 (1980).

²⁹ Rizzo, *Uncertainty, Subjectivity, Economic Analysis*, *supra* note 28, at 74.

³⁰ *Id.* at 79-80.

expectation of what the future flow of services from an opportunity not pursued would be. Determination of what alternative uses existed is also subjective.³¹ The difference between the market process and judicial decisionmaking, Rizzo states, is that

[a]t any given point in time, the market *process* does not take resource prices "literally." The expectations of participants—*upon whom the consequences of the inaccuracy of these expectations fall*—will serve to "correct" the misinformation of disequilibrium prices. The market, unlike the efficiency motivated common-law judge, is not a literalist.³²

Similarly, Murray Rothbard asserts that efficiency is a meaningless concept when applied to society because efficiency can only be measured against a defined goal and different members of society have different and often conflicting goals.³³

Robert Cooter and Lewis Kornhauser argue that the legal system will not adopt or retain efficient laws without the help of judges.³⁴ Further, they argue that while laws may be improved by insightful judges, few decisions reflect judges imposing an efficiency analysis from a cost benefit standpoint. In addition, they argue that there is no empirical evidence that

³¹ *Id.*

³² *Id.* at 81.

³³ Murray N. Rothbard, *Comment: The Myth of Efficiency, in TIME, UNCERTAINTY, AND DISEQUILIBRIUM* 90, 90 (Mario J. Rizzo ed., 1979). Rothbard argues that even an individual's actions cannot truly be determined to be efficient because no one possesses perfect knowledge of the future. Rothbard states that:

Put another way, action is a learning process. As the individual acts to achieve his ends, he learns and becomes more proficient about how to pursue them. But in that case, of course, his actions cannot have been efficient from the start—or even from the end—of his actions, since perfect knowledge is never achieved, and there is always more to learn.

Moreover, the individual's ends are not *really* given, for there is no reason to assume that they are set in concrete for all time. As the individual learns more about the world, about nature and about other people, his values and goals are bound to change. The individual's ends will change as he learns from other people; they may also change out of sheer caprice. But if ends change in the course of an action, the concept of efficiency—which can only be defined as the best combination of means in pursuit of given ends—again becomes meaningless.

Id. at 90.

³⁴ Robert Cooter & Lewis Kornhauser, *Can Litigation Improve the Law Without the Help of Judges?*, 9 J. LEGAL STUD. 139 (1980).

inefficient laws are litigated more frequently than efficient ones, or that more will be spent litigating against inefficient laws than defending them.

Gillian Hadfield has developed a model that suggests that even with efficiency-seeking judges, efficiency will not result.³⁵ Hadfield makes three basic arguments. The first is that given that the facts and circumstances of cases vary, even an efficient rule will only be efficient on average. For some of these cases, application of the rule may in fact be inefficient.³⁶ Second, courts can only decide those cases which come before them, and this represents a biased sample.³⁷ Further, the court may only use the information that the litigants provide, which will also show a selection bias and should not be expected to fully develop all ramifications of the judge's decision. Even the most economically sophisticated court would find it too costly to gather enough information to determine the efficient rule.³⁸

Bruce Kobayashi and John Lott have suggested that insufficient attention has been given to judges' preferences for goals other than efficiency, such as the desire to be cited more often in order to gain in reputation or to promote further litigation and thus work for their fellow lawyers. Their theory suggests that given such preferences, judges may favor inefficient rules over efficient ones.³⁹ However, Lawrence Blume and Daniel Rubinfeld, in an article suggesting that legal change will not occur over an optimal period, ascribe a different motivation for judges.⁴⁰ They claim that there is little incentive for judges to foster legal change over optimal time periods. Establishing new rules impacts a judge's career potential. Conversely, risk-adverse judges fear being overturned and adopt change incrementally, if at all.

Rubin himself has come to question the propensities of the common law to move towards efficiency. Recently Rubin and Bailey have applied an interest group analysis to explain legal change. They argue that the development of the law can best be understood by examining the ability of different classes of litigants to organize and pursue opportunities to change

³⁵ Gillian K. Hadfield, *Biases in the Evolution of Legal Rules*, 80 GEO. L.J. 583 (1992); see also Note, *The Inefficient Common Law*, 92 YALE L.J. 862 (1983).

³⁶ Hadfield, *supra* note 35, at 585.

³⁷ *Id.*

³⁸ *Id.*

³⁹ BRUCE H. KOBAYASHI & JOHN R. LOTT, JR., JUDICIAL REPUTATION AND THE EFFICIENCY OF THE COMMON LAW (Wharton School Working Paper 93-04, 1993); see also Jonathan R. Macey, *Civic Education and Interest Group Formation in the American Law School*, 45 STAN. L. REV. 1937, 1945 (1993).

⁴⁰ Lawrence E. Blume & Daniel L. Rubinfeld, *The Dynamics of the Legal Process*, 11 J. LEGAL STUD. 405, 418-19 (1982).

precedent through litigation. As an example, they assert that tort lawyers have the most interest in changing tort law in ways that benefit lawyers. Their conclusion is as follows:

In general, the common law will come to favor organized interest groups, just as does statute law. For those bodies of law where there are no other organized parties with strong interests in the form of the law, then the law should come to favor the interests of lawyers. A major result of this movement will be to increase the magnitude of damage payments and the degree of uncertainty of trial outcomes.⁴¹

Thus, law and economics has not yet developed a consensus on the nature of legal process. Although Posner continues to assert that the common law tends towards efficiency-promoting rules, there has been little theoretical and less empirical support for this proposition. Even Rubin, who set out one of the original models for the efficiency of the common law, has come to doubt that it is an accurate depiction of how the common law evolves. The idea that judges prefer efficient rules is suspect on two grounds. The one highlighted by the law and economics literature is that judges have other motivations which would drive them to prefer inefficient rules. The other is that judges do not have sufficient knowledge to determine what the efficient rule would be.⁴² This latter criticism is supported by Austrian economic theory and is the same criticism that Austrians have raised against the possibility of successful central planning. Even judges with a working knowledge of economics could not, in most instances, have the requisite information to determine the efficient rule. Although the value of economics in legal decisionmaking seems clear, the idea that judges on average possess the necessary background is questionable, and the idea that they naturally possess it is hard to defend.

In addition, the models do not reflect the fact that most of the function of the law has little to do with litigation. Most lawyers are involved in planning transactions and protecting their clients from having to go to court. A tax lawyer whose client has to spend money litigating against the Internal Revenue Service, for example, has already diminished the value of his or her services in tax planning. The lawyer who writes a contract that

⁴¹ PAUL H. RUBIN & MARTIN J. BAILEY, THE ROLE OF LAWYERS IN CHANGING THE LAW 34-35 (Emory University Law and Economics Working Paper Series No. 47, 1992).

⁴² However, judges with such knowledge would, of course, have more insight into the economic impact of their decisions. Henry Manne's law and economics programs for the judiciary educate judges on basic economic principles to help them bring economic insights into their decisionmaking process.

leaves unresolved issues that must be litigated has failed his or her client. The lawyer who drafts a will that is similarly challenged has not done what he or she was hired to do. In addition to the reputational effects of such failures, lawyers are open to malpractice suits if they are negligent. In many complex transactions, lawyers end up bearing some of the risk of the transaction being consummated as planned, either through contingent payment schemes or through liability for legal opinions that are successfully challenged. Focusing on involuntary transactions such as torts and litigation misrepresents what the majority of law and lawyering actually involves.

Further, in many instances, we cannot be sure we have reached the efficient rule, or know what that rule is. In truly voluntary transactions, one can safely assume that an efficient outcome was reached because otherwise the parties would not enter into the transaction. But legal rules may prevent or require certain transactions. At that point, a judgment must be made as to whether, if a voluntary transaction had been feasible, the parties would have entered into it. This approach tries to simulate the market by determining what the terms of a market transaction would have been.⁴³ Clearly the possibility for error is enormous. In addition, since often the result of the rule is a zero sum game, in that the winner takes all and the loser receives nothing, the actual result will not mirror a market transaction.

The other trend in law and economics literature is basically an application of a public choice model to the legal system. Thus, in Rubin's model, lawyers are interest groups, in effect lobbying for causes of action and legal rulings that will increase their business in the same fashion that interest groups lobby legislators. In Kobayashi and Lott, the judges take the place of the legislators, using the process to advance their own interests at the cost of the clients, who in the legislative model would be constituents or the general public, and currying favor with the interest groups, represented once again by the lawyers.

The implications of these models are similar to the criticisms of other schools of thought, usually thought to be antagonistic to law and economics, such as legal realism, or its modern counterpart, critical legal studies, which argue that the legal process is controlled by powerful entrenched segments of society who subvert the law for their own interests. If these models are accurate, then it is hard to find an argument for the legitimacy of legal process. Is this the only insight into legal process that law and economics can provide? Perhaps this is why Posner continues to

⁴³ POSNER, *supra* note 2, at 15.

assert that the common law is efficiency promoting. Law and economics does not otherwise have a theory that supports the validity of law as a societal institution.

Austrian economics can provide insights into legal process by viewing law as a discovery process, emphasizing the importance to society of reducing uncertainty and illuminating the entrepreneurial role of the legal profession. Austrian economics can thus help fill a jurisprudential void in the current law and economics literature.

III. HAYEK'S THEORY OF LAW

By far, the Austrian economist who has devoted the most attention to law is Friedrich Hayek. Hayek viewed the market process as the mechanism by which individuals in society adjust their individual plans, expectations, and goals to those of others. Economic interaction allows people to pursue their own ends, but at the same time reconciles their actions with those of the other members of their society.⁴⁴ Hayek saw the law as a social institution that facilitates the interaction of diverse members of society.

Hayek presents an evolutionary theory of social institutions. Those social institutions that function well survive, while those that are less successful are abandoned. Hayek stresses that these institutions develop as a result of "human action, but not of human design."⁴⁵ It may not be clear what the original purpose of the institution was. Rather its ability to adapt to changing circumstances and serve a useful function was its reason for surviving. This evolutionary nature of social institutions was first recognized by the Scottish moral philosophers, David Hume, Adam Smith, and Adam Ferguson, who drew upon the development of common law.⁴⁶ These philosophers, along with jurists such as British Chief Justice Mathew Hale, recognized that laws develop out of experience, are modified by subsequent developments, and after numerous iterations, become institutions, which provide certainty to the members of society.⁴⁷ This "emergence of order" did not depend on and could not have been created by human design. Nor did one have to posit some divine guidance. Rather, order emerged from evolutionary adaptation.⁴⁸ The evolutionary path

⁴⁴ FRIEDRICH A. HAYEK, *THE CONSTITUTION OF LIBERTY* 35 (1960).

⁴⁵ *Id.*

⁴⁶ *Id.* at 55-56.

⁴⁷ *Id.* at 58.

⁴⁸ *Id.* at 59.

would be indiscernible, *ex ante*.⁴⁹ Markets, laws, and other institutions that develop through evolution, not as a result of human design, can allow society to prosper and to exploit the dispersed knowledge and creativity that no one person or group of persons can possess. Centrally planned societies that choke off the possibility of spontaneous development can never achieve what freer societies can, and Hayek believed that eventually such societies would stagnate and fail.⁵⁰ Hayek uses this view of law and of social institutions to argue for the importance of freedom and liberty in providing the opportunities for undesigned developments and institutions.⁵¹ To the extent that deliberate action is taken to improve society, Hayek argues it should be done incrementally within existing frameworks and should not wholly redesign existing institutions.⁵²

In *The Constitution of Liberty*, Hayek asserts that governments should not try to create detailed laws, but rather law should be the product of unintended spontaneous order. This is represented by the common law, which Hayek sees as the product of countless decisions in which judges try to find the law, rather than create it. Hayek views government created laws as threats to liberty, for it makes the tyranny of the minority more likely.⁵³

⁴⁹ *Id.* at 56.

⁵⁰ *Id.* at 38; see also FRIEDRICH A. HAYEK, *THE ROAD TO SERFDOM* (1976).

⁵¹ HAYEK, *supra* note 44, at 61. Hayek includes the following quote from Oliver Cromwell at the head of chapter three in *THE CONSTITUTION OF LIBERTY*: "Man never mounts higher than when he knows not where he is going." *Id.* at 39.

⁵² *Id.* at 70. Hayek states:

What we must learn to understand is that human civilization has a life of its own, that all our efforts to improve things must operate within a working whole which we cannot entirely control, and the operation of whose forces we can hope merely to facilitate and assist so far as we understand them. Our attitude ought to be similar to that of the physician toward a living organism: like him, we have to deal with a self-maintaining whole which is kept going by forces which we cannot replace and which we must therefore use in all we try to achieve. What can be done to improve it must be done by working with these forces rather than against them. In all our endeavor at improvement we must always work inside this given whole, aim at piecemeal, rather than total, construction, and use at each stage the historical material at hand and improve details step by step rather than attempt to redesign the whole.

Id. at 69–70 (footnote omitted).

⁵³ *Id.* at 153–54. For Hayek's discussion of judicial and legislative processes, see 1 FRIEDRICH A. HAYEK, *LAW, LEGISLATION, AND LIBERTY* 94–144 (1973).

Hayek distinguishes between abstract rules of law and arbitrary government, which commands particular outcomes through legislation. Although both involve some limitations on individual freedom, abstract rules create the conditions under which resources may be used or transactions carried out. These rules provide guidelines for actions without reference to particular facts and circumstances. An example of this type of rule is one that tells people which side of the road to drive on without telling them where to go. These rules cultivate the conditions that may assist economic growth rather than attempt to engineer growth by decree.⁵⁴

An ideal law is general and abstract and applies equally to all.⁵⁵ Such laws allow maximum freedom to the individual who uses the law as part of his knowledge base in his or her decision concerning what action to take.⁵⁶ Because the rules laid down by this ideal type of law are general and not framed for a particular case, they are not likely to impose severe restrictions on liberty. This is because if the law applies to all, both the lawmakers and the governed, Hayek believes there is little that anyone would want to do that would be prohibited.⁵⁷

Within Hayek's conception of law, however, there can be laws which by their nature will apply to only one group in society because of properties, such as the ability to bear children, that only that group possesses. But Hayek posits an interesting test for the legitimacy of such laws, one that is very contemporary in flavor despite being written more than thirty years ago. Hayek asserts that such laws are not arbitrary and not an appropriation of power by one part of society over another "if they are equally recognized as justified by a majority both inside and outside of the group."⁵⁸ Hayek goes on to state:

This does not mean that there must be unanimity as to the desirability of the distinction, but merely that individual views will not depend on whether the individual is in the group or not. So long as, for instance, the distinction is favored by the majority both inside and outside the group,

⁵⁴ Lachmann has described this as gardening rather than engineering. LUDWIG M. LACHMANN, *CAPITAL, EXPECTATIONS, AND MARKET PROCESS* 323-27 (1977).

⁵⁵ HAYEK, *supra* note 44, at 153.

⁵⁶ *Id.*

⁵⁷ *Id.* at 155. One would assume that Hayek would look with suspicion on laws that Congress enacts for the population generally, but excepts itself from having to comply, such as laws against sex discrimination and harassment in the workplace. However, this congressional practice may cease in light of the Congressional Accountability Act of 1995. H.R. 1, 104th Cong., 1st Sess. (1995) (this bill passed in both the House and the Senate and is pending presidential approval).

⁵⁸ *Id.* at 154.

there is a strong presumption that it serves the ends of both. When, however, only those inside the group favor the distinction, it is clearly privilege; while if only those outside favor it, it is discrimination. What is privilege to some is, of course, always discrimination to the rest.⁵⁹

Hayek distinguishes those laws that meet these criteria from specific commands. Governments that issue commands through legislation choose arbitrarily between different groups of people and different ends.⁶⁰ Commands define the action to be taken. The men and women on whom the commands are imposed are stripped of any freedom to use their individual knowledge or discretion. The sole purpose of the command is to serve the issuer and not the actor.⁶¹ Commands limit the knowledge that is utilized to that of the person who issues the command. There is no ability to utilize the knowledge or judgment of the actors.⁶² Commands are specific and concrete whereas laws are general and abstract.⁶³

Clearly there is a range between the ideal law and the ideal concept of a command in which more or less freedom is given to those who are subject to the law or command. Orders that are issued by legislators can be laws or commands, depending on the form which they take.⁶⁴ To be laws in the Hayekian sense, they must be general and abstract.

Because laws are general and abstract, they will result in unintended consequences. There is no way anyone can foresee all the consequences of a given law, partly because of his or her own ignorance and partly because there is no way to predict how an individual will utilize the law in decisionmaking.⁶⁵ Thus, an Austrian framework rejects the theory that laws will necessarily tend towards efficiency or that a judge would somehow be able to discern what the efficient result would be. Only experience can show the value of a law or its expediency.

Rules can never be made wholly unambiguous. This is a natural result of human imperfection. The role of the courts is to ensure an impartial tribunal with a neutral judge to determine how to apply the law to the parties.⁶⁶ Hayek's position is that one must have faith in the spontaneous evolution of institutions and the advancement of knowledge, recognize that

⁵⁹ *Id.*

⁶⁰ ALEXANDER H. SHAND, *THE CAPITALIST ALTERNATIVE* 190 (1984).

⁶¹ HAYEK, *supra* note 44, at 150.

⁶² *Id.*

⁶³ *Id.* at 151.

⁶⁴ *Id.* at 155-56.

⁶⁵ *Id.* at 158.

⁶⁶ *Id.* at 226.

there will be undesigned change, and acknowledge the rights of those with whom we disagree to obey their convictions within a political order. The fundamental purpose of the rule of law is to allow people with different values to coexist peacefully within society with a minimum of force.⁶⁷

As Hayek stated in *The Constitution of Liberty*:

We shall see that the observation of the rule of law is a necessary, but not yet a sufficient, condition for the satisfactory working of a free economy. But the important point is that all coercive action of government must be unambiguously determined by a permanent legal framework which enables the individual to plan with a degree of confidence and which reduces human uncertainty as much as possible.⁶⁸

IV. LAW AS A DISCOVERY PROCESS

A. *The Evolution of Law*

A basic principle of economics is that the market creates a spontaneous order.⁶⁹ Karen Vaughn has noted that Hayek saw two aspects to the spontaneous order. The first was the "orderly process of exchange within the context of a set of widely understood rules."⁷⁰ The second was the "unplanned and often unconscious changes in rules and institutions that occur as the by-product of purposive actions."⁷¹ Vaughn noted: "[Hayek's] understanding of the market discovery procedure led him to examine the origin of all social institutions from the perspective of the limitations on knowledge that constrain individual choices."⁷² With respect to legal institutions, Hayek emphasized the evolutionary nature of the law and the legitimacy of the law. He was less concerned with the process by which law evolved.

Ludwig Lachmann further developed the role of institutions as providing orientation for human plans which are always made in an uncertain and changing world. Institutions must be relatively stable, but

⁶⁷ *Id.* at 402.

⁶⁸ *Id.* at 222.

⁶⁹ James Buchanan has suggested that this is the only principle of economics. See Gerald P. O'Driscoll, Jr., *Spontaneous Order and the Coordination of Economic Activities*, 1 J. LIBERTARIAN STUD. 137, 139 (1977).

⁷⁰ KAREN I. VAUGHN, *AUSTRIAN ECONOMICS IN AMERICA* 125 (1994).

⁷¹ *Id.* Menger's theory of the evolution of money as a medium of exchange is an example of a societal institution that evolved over time.

⁷² *Id.* at 126.

must be flexible enough to allow for societal change and progress and for new institutions to solve new problems.⁷³ As Vaughn has noted, however, Lachmann also did not develop a theory about how institutions adapt.⁷⁴

Because Austrians emphasize the market process, their analysis is more focused on the cognitive aspects of functioning in society. By focusing on process rather than equilibrium states, Austrians see as critical the need for individuals to be able to deal with uncertainty and change. Lachmann has described market process as the "outward manifestation of an unending stream of knowledge" and stressed the difficulty neoclassical economics has accommodating changing knowledge as follows:

Knowledge then is an elusive concept wholly refractory to neoclassical methods. It cannot be quantified, has no location in space, and defies insertion into any complex of functional relationships. Though it varies in time, it is no variable, either dependent or independent. *As soon as we permit time to elapse, we must permit knowledge to change, and knowledge cannot be regarded as a function of anything else.* The state of knowledge of a society cannot be the same at two successive points of time, and time cannot elapse without demand and supply shifting. The stream of knowledge produces ever new disequilibrium situations, and entrepreneurs continually manage to find new price-cost differences to exploit. When one is eliminated by strenuous competition, the stream of knowledge throws up another.⁷⁵

Legal institutions provide the intellectual framework for interacting in society, reducing uncertainty, and establishing some common ground. In our daily lives and business dealings, we take for granted many legal rules that have become part of our tacit or express knowledge. These legal rules allow us to perform many tasks without having to explicitly concern ourselves with the law. In addition, more complex transactions rely on sets of legal rules to support the understandings of the parties, and these transactions could not be carried on without the legal framework setting forth each party's obligations and liabilities.

The legal system must, however, also be able to adapt to new knowledge and new circumstances. Changes in technology and other societal changes put pressure on the legal system. For example, as computer software became more widely used, new issues of protecting

⁷³ LUDWIG M. LACHMANN, *THE LEGACY OF MAX WEBER* 89–90 (1971); *see also* VAUGHN, *supra* note 70, at 157.

⁷⁴ VAUGHN, *supra* note 70, at 168–69.

⁷⁵ Ludwig M. Lachmann, *On the Central Concept of Austrian Economics: Market Process*, in *THE FOUNDATIONS OF AUSTRIAN ECONOMICS* 127–28 (E. Dolan ed., 1976).

intellectual property rights arose that were unique to the technology. The last two decades have witnessed the struggles of courts and Congress to determine what actually can be protected so as to afford protection for intellectual property without hampering technology growth. As one commentator described the problem:

[It] is apparent from the ensuing litigation that present legal theories are less than adequate to protect this valuable magnetic property. It has become clear that the law of software protection is in a state of rapid development that will take many years to stabilize.

The fundamental problem is the inability of an established legal system, based on protection of *tangible* property, to cope with a form of property that can appear and disappear with the speed of light.⁷⁶

As technology develops, the legal system has to be able to advance to accommodate those technologies. The process is not always, and perhaps not often, a smooth one, and in cases of technology growth the law will often lag behind. Further, societal developments are reflected in the legal system as legal rules, and litigation helps to redefine the obligations of government and individuals to the society. In these areas, the law may lead or push society, and actual social change may lag behind the legal rules as expectations change to accommodate the new rules. The history of school desegregation in this country is an example of the court redefining societal obligations, and even forty years after the Supreme Court held that segregated public schools were unconstitutional, school districts continue to struggle to fulfill their obligation to provide integrated schools.⁷⁷

Analyzing law as a process, similar to the Austrian market process, focuses on law as a creative and cognitive discipline. A major goal of the process is to reduce uncertainty while being able to accommodate change. It is the ability of people to coordinate their actions within laws that apply equally to all that provides the framework for a spontaneous order, and only a spontaneous order will allow society to approach the maximization of its resources by allowing all knowledge to be utilized and providing a structure in which knowledge will be advanced. Legal institutions, to the extent they clarify the terms under which people interact in the market,

⁷⁶ G. GERVAISE DAVIS III, SOFTWARE PROTECTION 2 (1985). For a general discussion of how to prepare law students to deal with emerging areas of technology, see Linda A. Schwartzstein, *Legal Education, Information Technology and Systems Analysis*, 13 RUTGERS COMPUTER & TECH. L.J. 59 (1987).

⁷⁷ For a discussion of the problems in the Kansas City, Missouri school district, see Linda A. Schwartzstein, *Bureaucracy Unbounded: The Lack of Effective Constraints in the Judicial Process*, 35 ST. LOUIS U. L.J. 597 (1991).

increase the likelihood that individuals will achieve their goals. In this framework, legal precedent functions both to limit what needs to be decided and to provide information which people can incorporate into their stock of knowledge. Without needing to know what gave rise to the rule, or the rationale behind it, individuals can use the outcome to adjust their future actions and to form expectations of how those with whom they come in contact with will act. Many legal rules are fixed, but because of uncertainty and changing circumstances, it will never be possible to set down a system of rules that clearly defines every conceivable situation. As discussed below, lawyers serve the function of entrepreneurs in the legal process, and through this role, are the major force that pushes the law to adapt. By seeking out new legal concepts and interpretations, lawyers decrease gaps in the system of legal rules and keep law moving forward with society. Lawyers must be able to identify what rules exist, find ways to apply them in their clients' best interests, and be creative in shaping the rules so as to best further those interests. Lawyers who deviate from forwarding their clients' interests to advancing their own will be disciplined not only by ethical rules but also by reputational loss.

B. The Diffusion of Knowledge and the Reduction of Uncertainty

Austrian economics, which emphasizes subjectivism, suggests that there is nondeterminism with respect to societal institutions. That is, outcomes are not preordained.⁷⁸ This nondeterminism should be contrasted with the indeterminacy that critical legal studies claims to see in legal process. Indeterminacy suggests that at any time, any outcome is possible. The Austrian view of nondeterminism is that the process puts boundaries on the possible outcomes, just as market prices limit the potential economic opportunities. At any time, an entrepreneur may discover an unexploited opportunity or create such an opportunity, and the market process will allow or not allow it to thrive. However, this opportunity is within the context of the feasible. Similarly, legal process narrows the possible outcomes over time. Since every case has its own set of facts and circumstances, and since society continuously changes over time, there is always the possibility that an entrepreneurial attorney will discover a new interpretation or convince a court that a novel cause of action is appropriate. However, these legal innovations will have to come within an existing legal framework or be rejected. In addition, once a principle of law is tested several times and a prevailing standard emerges from the

⁷⁸ G.L.S. Shackle, *Foreword* to SHAND, *supra* note 60, at xi.

process, the possible outcomes of similar cases in the future will have been narrowed. Thus, law is not indeterminate in the sense that any outcome can occur at any time. Rather, it is nondeterminate because there is no endpoint to the process and new developments will continue to force the process to evolve.

Recognizing the complexity of the legal process, with all the individual actions that impact on the creation, application, and enforcement of rules, makes it clear that, just as with the market process, all of the circumstances that will determine the result may not be known or may not be measurable. Results that may appear random or indeterminate may seem so only because some of the influences on those results may not have been perceived or accurately reflected in the analysis. Similarly, models such as those in neoclassical law and economics that suggest that outcomes should be predictable or able to be pierced by statistical analysis may result in inaccurate theories, conclusions, or recommendations because those factors that are not quantifiable will tend to be ignored.⁷⁹

When one views the legal system from the perspective gained from Austrian concepts of market process, one sees that a central function of the legal system and legal institutions is to diffuse knowledge and to allow individuals to interact and function with limited amounts of information. The philosopher A. N. Whitehead said that "[c]ivilization advances by extending the number of important operations which we can perform without thinking about them."⁸⁰

Coordination of economic plans occurs partly through the legal system, but we can also look at the legal system as a dynamic process that is part of the plan adjustment. The legal system must reduce uncertainty and convey information to the people who need it without requiring them to understand the reasons why the rules have been set up in a particular way. Many people can live with a particular rule, especially if the rule does not change constantly by legislative action. As long as they know what the rules are, they can accommodate their actions to fit those rules.

As a legal concept is clarified through repeated applications in the courts, it will take a more definite shape and eventually may be in equipoise, where parties will no longer litigate the issue, but instead, will accept the concept as part of their implicit or explicit understanding of the law. However, as new developments arise, or new interests become represented, some previously accepted legal institutions will be challenged. The current legal equilibrium may survive this challenge. It may be

⁷⁹ SHAND, *supra* note 60, at 7; Friedrich A. Hayek, *The Pretense of Knowledge*, 79 AM. ECON. REV. 3 (1974).

⁸⁰ HAYEK, *supra* note 44, at 22 (quoting A.N. Whitehead).

replaced by a new equilibrium. Or the law will be uncertain for a considerable period of time. Thus, a state of "legal disequilibrium" may exist for a period of time.

C. The Lawyer as Entrepreneur

Austrian economics views the market process as a discovery process and emphasizes the role of the entrepreneur. The entrepreneur discovers previously overlooked opportunities, creates new ones, and corrects errors in the market through arbitrage. Even entrepreneurial failures convey information to the other market participants. The entrepreneur is not simply a maximizer of objective information. Rather, the entrepreneur sees possibilities that do not occur to others looking at the same objective data.⁸¹

By recognizing legal process as a discovery process similar to the market process described by Austrian economics, one can see that the lawyer acts as an entrepreneur. Like his or her counterpart in the market process, lawyers look for new opportunities to advance their clients' interests by finding winning arguments and new interpretations of the law as necessary. By so doing, they push the law to advance and stretch to encompass novel situations, making the development of the law a dynamic rather than a static process. The entrepreneurial role of judges is more restricted because judges' reputations are enhanced if they are perceived to be careful jurists who display caution and respect for prior rules. Thus, it is mainly the lawyer as entrepreneur who will be the prime mover for novel theories of law.

The entrepreneurial aspects of lawyering also suggest that lawyers will organize as an interest group only in a limited set of circumstances. Just as an entrepreneur in the market profits by being the first to exploit a new opportunity, a lawyer often gains a competitive advantage over other lawyers by being the first to advance a new legal theory—creating a reputation that draws clients with similar concerns to hire him or her as opposed to his or her competitors. Similarly, lawyers prosper by specialization—gaining comparative advantages over other lawyers by their expertise in a particular area. The more sophisticated and specialized their knowledge, the more protected their practice is from competition. Conversely, the lawyers who have only generalized knowledge are

⁸¹ SHAND, *supra* note 60, at 89–90; *see also* ISRAEL M. KIRZNER, *COMPETITION & ENTREPRENEURSHIP* (1973); VAUGHN, *supra* note 70, at 143.

constantly being threatened by other lawyers (and indeed, in some cases, by computer programs).

The competition in the legal market means that lawyers' self-interest will lead them to share their knowledge only to a limited extent. To the extent that they can keep their solutions to legal problems or their approaches to structuring transactions in a particular area proprietary and nonpublic, they advance their own interests. Clients will seek them out because of their expertise, and other lawyers will refer particular types of business or cases to them because the costs of duplicating their knowledge is too burdensome to attempt to replicate the expertise. Rather than having an interest in sharing their knowledge with other lawyers, lawyers have an interest in limiting the exposure of their knowledge and creating areas in which possible competitors will feel incompetent to tread.

The entrepreneurial aspects of lawyering make interest group analysis only appropriate in those cases where lawyers believe it is in their self-interest to act as a united group to advance a novel area of the law. This is most likely to happen where the individual lawyer has proven unable to advance the law in a manner beneficial to the types of clients that lawyer represents or seeks to represent. In such cases, lawyers may use interest groups to generate pressure for the law to move in a particular direction. The cost to the lawyer of using the interest group is that it makes the legal theories more public and thus, more subject to appropriation by competing attorneys. The benefits of an interest group approach would clearly have to be sufficient to overcome these costs and would likely be a second-best solution for the lawyers involved.

Just as the marketplace disciplines entrepreneurs, rewarding or rejecting their innovations, the courts discipline entrepreneurial lawyers. Thus, while lawyers constantly push the legal process and discover new opportunities, the judicial process, with its interest in protecting certainty and reliance interests, serves to temper these forces.

V. LEGAL RULES AND EQUILIBRIUM: THE FALSE DICHOTOMY BETWEEN RULES AND STANDARDS

Rather than maximizing efficiency, as Posner claims, this Article argues that the legal process tends to maximize certainty. Courts are clearly sensitive to the fact that an important part of the legal process is to reduce uncertainty, especially with respect to areas in which people rely on certain legal frameworks to plan their affairs. The legal doctrines of *stare decisis* and *res judicata*, which require respect for earlier decisions, support this goal. Even an inefficient but stable rule may be preferable to a court

changing a rule because of the uncertainty that such change engenders. This concern of the courts has at times been explicitly expressed. Justice Brandeis once stated:

Stare decisis is usually the wise policy, because in most matters it is more important that the applicable rule of law be settled than that it be settled right. This is commonly true even where the error is a matter of serious concern, provided correction can be had by legislation.⁸²

The ability of the courts to provide certainty depends on the type of issues before the court. By viewing legal process from the standpoint of the reduction of uncertainty, one can make predictions as to what extent a definite rule will develop and to what extent there will be only standards which may become better defined over time. It is easy to have fixed rules for such mundane and stable aspects of society such as what side of the road to drive on, or what to do on red, yellow, and green traffic lights.⁸³ Here, the facts and circumstances are not subject to wide-ranging variance, technology is relatively stable, and people's expectations are constant. However, it is impossible to have a fixed set of rules for those aspects of society that are most often in a state of change or disequilibrium. Even in these areas, though, court decisions slowly narrow the range of possible outcomes, thus reducing uncertainty, although not eliminating it.

There are several types of issues that the court can resolve with a clear rule. Among these are cases in which the court must interpret a technical aspect of a statute and cases in which the intent of the parties is not important. Similarly, cases in which parties have the ability to plan their transaction once the rule is established or the issues arise only in a relatively narrow set of circumstances lend themselves to resolution by a clear, specific rule.

In these cases, once the courts have established a "bright-line" test or a specific interpretation of statutory language, they are reluctant to overturn the established rule because courts recognize that people will have relied upon the rule in their planning. The rule will often be upheld, notwithstanding that the decision may seem somewhat outdated or that the rationale may be questionable.

⁸² *Burnet v. Coronado Oil & Gas Co.*, 285 U.S. 393, 406 (1932) (Brandeis, J., dissenting) (citations omitted).

⁸³ Even this rule underwent change, allowing right turns on red lights in order to promote fuel efficiency; however, it moved from one stable point to another stable point.

A recent United States Supreme Court case, *Quill Corp. v. North Dakota*,⁸⁴ provides an example. The State of North Dakota brought an action in state court to require Quill Corporation, an out-of-state mail order house, to collect and pay use taxes on sales made in the state. Quill Corporation had no outlets or sales representatives within North Dakota, but mailed twenty-four tons of catalogues to North Dakota residents each year. An earlier Supreme Court case, *National Bellas Hess, Inc. v. Department of Revenue*,⁸⁵ decided in 1967, had held that a similar attempt by Illinois to impose a use tax on mail order houses located in other states was an unconstitutional burden on interstate commerce and violated the Due Process Clause of the Fourteenth Amendment. The Supreme Court of North Dakota refused to follow *Bellas Hess* and held that the tremendous social, economic, commercial, and legal innovations of the past quarter century had rendered *Bellas Hess* obsolete.⁸⁶ The North Dakota court said that changes in the economy and the law made the *Bellas Hess* decision anachronistic. The chief economic change, it noted, was the tremendous growth of the mail order business and the increased technological ability to collect the taxes that made compliance less burdensome.⁸⁷ In addition, the court noted some changes in the interpretation of the Commerce Clause and the Due Process Clause which it believed supported its decision.⁸⁸ The United States Supreme Court overruled the state supreme court decision, notwithstanding the fact that it agreed with much of the state court's reasoning.⁸⁹

The Court held that the Due Process Clause would allow the imposition of the tax despite the lack of physical presence within the state,⁹⁰ but upheld the *Bellas Hess* prohibition of state use taxes on mail order houses under the Commerce Clause.⁹¹ The Court said that *Bellas Hess* created a "safe harbor" for mail order vendors, by establishing a bright-line rule that such vendors were not subject to state use taxes. Although it recognized that such bright-line tests are artificial in some circumstances, the Court believed this artificiality was more than offset by

⁸⁴ 112 S. Ct. 1904 (1992).

⁸⁵ 386 U.S. 753 (1967).

⁸⁶ *North Dakota v. Quill Corp.*, 470 N.W.2d 203, 208 (N.D. 1991), *rev'd*, 112 S. Ct. 1904 (1992).

⁸⁷ *Id.* at 208-09, 213.

⁸⁸ *Id.* at 216.

⁸⁹ *Quill*, 112 S. Ct. at 1907.

⁹⁰ *Id.* at 1911.

⁹¹ *Id.* at 1914.

the benefits of a clear rule because the rule limits permissible state action and reduces litigation.⁹² The Court went on to state:

Moreover, a bright-line rule in the area of sales and use taxes also encourages settled expectations and, in doing so, fosters investment by businesses and individuals. Indeed, it is not unlikely that the mail-order industry's dramatic growth over the last quarter-century is due in part to the bright-line exemption from state taxation created in *Bellas Hess*.⁹³

Recognizing that in other contexts it had adopted more contextual rules, the Court distinguished this case based on its perception that people had relied on the established rule in their business planning.⁹⁴ Finally, the Court noted that Congress could overturn its decision if it so desired.⁹⁵

In other cases, the Court can only provide contextual guidelines. In areas in which the variety of factual decisions that may arise are great and in which the intent of the parties is important to the outcome, courts are less able to establish clear rules. In these cases, the courts tend to resort to descriptive guidelines, which may be clarified as more cases are litigated. However, subsequent litigation will tend to clarify the legal outcome in factually similar cases.

The evolution of the law regarding the taxation of payments to an employee's widow will demonstrate this evolutionary process. In *Commissioner v. Duberstein*,⁹⁶ the Supreme Court had to determine whether certain transfers between taxpayers constituted gifts for purposes of the Internal Revenue Code ("Code"). The Code excludes gifts from the income of the recipient for tax purposes. However, the statute provides no guidance as to what constitutes a gift. The factual settings before the Court involved situations where the transfers at issue were made in a business setting. The Internal Revenue Service ("IRS") wanted the Court to adopt a bright-line rule that transfers in business settings could never be gifts for purposes of the tax laws. The Supreme Court rejected the proposed test on the grounds that it was potentially overbroad. The Court stated:

⁹² *Id.* at 1914–15.

⁹³ *Id.* at 1915.

⁹⁴ *Id.* at 1915–16.

⁹⁵ *Id.* at 1916.

⁹⁶ 363 U.S. 278 (1960).

The Government suggests that we promulgate a new "test" in this area to serve as a standard to be applied by the lower courts and by the Tax Court in dealing with the numerous cases that arise. We reject this invitation. We are of the opinion that the governing principles are necessarily general and have already been spelled out in the opinions of this Court, and that the problem is one which, under the present statutory framework, does not lend itself to any more definitive statement that would produce a talisman for the solution of concrete cases.

. . . .

Decision of the issue presented in these cases must be based ultimately on the application of the fact-finding tribunal's experience with the mainsprings of human conduct to the totality of the facts of each case. The nontechnical nature of the statutory standard, the close relationship of it to the data of practical human experience, and the multiplicity of relevant factual elements, with their various combinations, creating the necessity of ascribing the proper force to each, confirm us in our conclusion that primary weight in this area must be given to the conclusions of the trier of fact.⁹⁷

Justice Frankfurter, concurring in part and dissenting in part to the decision, objected that the Court's approach gave no guidance to lower courts. He predicted that there would be disparate results when factually similar cases came before the lower courts.⁹⁸

One area in which Justice Frankfurter's concern was borne out was with respect to noncontractual payments by employers to widows of deceased employees. Some courts found that such payments were gifts, while others found that they were income. Within the broad range of settings in which possible gifts could be made, these cases presented such similar sets of facts that different results were hard to justify. Eventually, the Second Circuit interpreted *Duberstein* in a way that allowed more certainty with respect to widows' payments. In *Estate of Carter v. Commissioner*,⁹⁹ the Second Circuit stated:

We cannot believe the Supreme Court intended that, at least in an area where, in contrast to the entire field of controversy with respect to gifts versus compensation, similar fact patterns tend to recur so often, the result should depend on whether a widow could afford to pay the tax and sue for a refund rather than avail herself of the salutary remedy Congress intended to afford in establishing the Tax Court and permitting determination

⁹⁷ *Id.* at 284-85, 289 (citations and footnotes omitted).

⁹⁸ *Id.* at 295-98.

⁹⁹ 453 F.2d 61 (2d Cir. 1971).

before payment. The “mainsprings of human conduct” do not differ so radically according to who tries the facts.¹⁰⁰

The Second Circuit decision in *Estate of Carter* served to provide greater certainty with respect to the treatment of employer payments to widows of employees. Thus, within areas that do not allow for bright-line tests, eventually smaller areas of certainty will emerge as the courts see enough similar factual contexts to enunciate more definitive rules for transactions falling within that smaller realm.

The Court appears most willing to change its prior holding in constitutional cases when it believes that it would be difficult or impossible for Congress to provide a legislative remedy or correct a bad policy. Thus, Justice Brandeis noted:

But in cases involving the Federal Constitution, where correction through legislative action is practically impossible, this Court has often overruled its earlier decisions. The Court bows to the lessons of experience and the force of better reasoning, recognizing that the process of trial and error, so fruitful in the physical sciences, is appropriate also in the judicial function.¹⁰¹

This leads to the counterintuitive result that decisions involving constitutional issues may be less stable than decisions involving legislative ones. In *Payne v. Tennessee*,¹⁰² an Eighth Amendment case concerning the admissibility of victim impact testimony in a death penalty case, the Supreme Court stated:

Stare decisis is not an inexorable command; rather it “is a principle of policy and not a mechanical formula of adherence to the latest decision. . . .” This is particularly true in constitutional cases, because in such cases “correction through legislative action is practically impossible.” . . . Considerations in favor of *stare decisis* are at their acme in cases involving property and contract rights, where reliance interests are involved, . . . [but] the opposite is true in cases such as the present one involving procedural and evidentiary rules.

¹⁰⁰ *Id.* at 69 (citations and footnotes omitted).

¹⁰¹ *Burnet v. Coronado Oil & Gas Co.*, 285 U.S. 393, 406–08 (1932) (Brandeis, J., dissenting) (footnotes omitted).

¹⁰² 501 U.S. 808 (1991).

Applying these general principles, the Court has during the past 20 Terms overruled in whole or in part 33 of its previous constitutional decisions.¹⁰³

The decision went on to note the inability of lower courts to apply the earlier Supreme Court decisions in this area consistently.¹⁰⁴

Thus, the courts will adopt rules where there is not much variance in factual settings or where a statute permits a bright-line interpretation. Once the rules are established, courts are reluctant to overturn them, given the economic importance of legal certainty, even when the court believes that a different result may be more appropriate if the issue was being decided *de novo*. In areas where a bright-line rule is not possible, the courts adopt guidelines, which will be filled in by more specific rules for factually similar situations. However, courts, especially the Supreme Court, are more willing to change rules involving interpretation of the Constitution when the court perceives itself as the only arbiter of legal change.

VI. CONCLUSION

Austrian economics provides a different framework from which to examine legal process that advances jurisprudence regarding the evolution of legal institutions. Rather than viewing the legal system as maximizing efficiency or as manipulated by interest groups, Austrians believe that the purpose of the law is to foster certainty and to provide guidelines for social, including market, interactions. The evolution of legal institutions is always an ongoing process, and the law adapts to accommodate changing circumstances. The degree of certainty provided by the law will depend on the type of issue that needs resolution. Lawyers, acting as entrepreneurs, both navigate within the existing framework and push to change the framework, thus providing an impetus for change. These changes will most likely be incremental rather than revolutionary, thus allowing for a large degree of certainty, and at the same time, adaptability.

¹⁰³ *Id.* at 828-29 (citations omitted).

¹⁰⁴ *Id.* at 830.